Macroprudential policy and monetary policy

One important lesson from the financial crisis is that supervision of individual institutions is not enough to safeguard financial stability. An active policy is also needed to manage and counteract risks threatening the financial system as a whole. This new policy area is called macroprudential policy. Its aim is to increase the financial system's resilience to disruptions in the financial system and to prevent the build-up of financial imbalances in the economy. The Government has recently proposed giving Finansinspektionen the main responsibility for macroprudential policy tools, including the countercyclical capital buffer. This clarification of responsibility will create better conditions, among other things, for the reduction of the risks inherent in household indebtedness. As different macroprudential policy instruments are introduced and knowledge increases over how they function in practice, the consequences for monetary policy will gradually become clearer. The Riksbank's tasks and objectives remain unchanged. As before, the Riksbank will need to monitor and analyse risks and resilience in the financial system, partly to see how these affect economic developments in general and thus monetary policy, and partly to contribute to promoting financial stability.

The financial crisis that broke out in the autumn of 2008 following the crash of the US investment bank Lehman Brothers has demonstrated the enormous costs that impact society when the financial system stops working.[47] In many countries, companies and banks filed for bankruptcy with high unemployment as a consequence. The debt burden of the public sector increased when governments were forced to intervene to support the banking system. In turn, this entailed major cutbacks in the public sector.

One important lesson from the financial crisis is that the supervision of individual institutions is not enough to safeguard financial stability but that an active policy is needed to manage and counteract risks threatening the financial system as a whole. This implies a clearer focus on preventing systemic risks, which is to say preventing risks threatening the functionality of the financial system. Consequently, comprehensive international work is underway to strengthen the resilience of the financial system. A new policy area, known as macroprudential policy, has emerged, the aim of which is to increase the financial system's resilience to disruptions and also to prevent the build-up of financial imbalances in the economy.[48] Macroprudential policy should be seen as a complement to traditional supervision (microprudential supervision), which focuses on individual institutions.

At the European level, the European body for macroprudential policy, the European Systemic Risk Board (ESRB), (plays an important role.

[47] The cost to society of the global financial crisis, in terms of lost growth, has been estimated at between 1 and 5 times global GDP by some economists (see Haldane, Andrew (2010), The $100 Billion Question). Speech, Bank of England.
[48] However, the term macroprudential has existed since the 1970s – see Clement, Piet (2010), The term 'macroprudential': origins and evolution. *BIS Quarterly Review* March 2010.

Among other measures, the ESRB has issued a recommendation on interim targets and instruments for macroprudential policy in the EU countries.[49] It is thereby contributing to the development of a well-functioning toolbox for macroprudential policy by the EU countries. Macroprudential policy tools are normally divided into structural tools, that is, tools intended to reduce the structural risks in the financial sector, and cyclical tools, which are intended to vary over time.

The Government proposes that Finansinspektionen will be given the main responsibility for the macroprudential tools

The Government has recently proposed giving Finansinspektionen the main responsibility for macroprudential policy tools, including the countercyclical capital buffer.[50] The Government also proposes establishing a formalised financial stability council, consisting of the minister for financial markets and the heads of Finansinspektionen, the Riksbank and the Swedish National Debt Office. This council is to act as a forum with minuted meetings, but not as a decision-making body. The council gives the participating parties the opportunity to discuss risks in the financial system and their assessments of appropriate measures to manage and counteract such risks.

It is positive that the Government has made a decision on where responsibility for macroprudential policy is to lie. This will create better conditions to reduce the risks inherent in household indebtedness, among other things. However, the work on counteracting financial imbalances is relevant for several different policy areas. It is therefore good that the authorities working on these issues are given the opportunity to meet and hold discussions in the formalised financial stability council.

With this, the Riksbank's tasks and objectives remain unchanged. The Riksbank aims to maintain price stability and promote a safe and efficient payment system. In practice, this latter means promoting stability in the financial system. In addition, without prejudice to the objective of price stability, the Riksbank is to support the targets for general economic policy, the aim of which is to achieve sustainable growth and high employment. This will give the Riksbank a central role in ensuring that macroeconomic development is sustainable and stable.

Macroprudential policy and monetary policy largely act through the same channels

Monetary policy and macroprudential policy both influence the financial conditions on various financial markets. The policy rate has a direct effect on the interest rate the banks apply when they lend to and borrow from each other from one day to the next. Changes to this, the overnight rate, then spread to interest rates with longer maturities and higher credit risk. The Riksbank publishes a forecast for the policy rate, which also contributes towards influencing interest rates with longer maturities. The banks fund a large part of their lending with deposits, which often have a

[49] The ESRB's tasks are to identify risks to the stability of the EU's financial system and to issue warnings and/or recommendations in the case of serious risks.
[50] See Swedish Ministry of Finance (2013), Ett förstärkt ramverk för finansiell stabilitet [A stronger framework for financial stability] (only in Swedish), memorandum, 26 August 2013.

relatively short maturity. Monetary policy thus influences the banks' funding costs and the amount of credit in the economy when the policy rate is adjusted. A policy rate increase normally dampens demand and the rate of inflation in the economy, and the reverse when the policy rate is lowered.[51]

Certain macroprudential policy instruments also act by restricting or increasing the amount of credit in the economy in various ways.[52] The **countercyclical capital buffer** is a new tool included as a part of the new capital adequacy regulations, Basel III.[53] During periods in which the risks in the financial system are increasing, the banks will be required to build up capital buffers that can then be used when the risks are realised or decline.[54] The instrument will thereby have a direct effect on the financial system's resilience, but can also contribute towards restricting credit growth and debt accumulation. It is normally more expensive for the banks to fund their operations with equity than with loans.[55] An increase of the capital buffer will therefore increase the banks' funding costs, which may entail higher lending rates and thus reduced lending. However, the countercyclical capital buffer has a more explicit influence than monetary policy with regard to the relative price of risk in the economy. An increase in the buffer makes high-risk lending relatively more expensive than lending with a low risk.

The countercyclical capital buffer is a powerful but blunt instrument that affects all lending by the banks. If any problems were to be concentrated on a certain sector, **sectoral capital requirements**, which is to say capital adequacy requirements focused on a certain sector, could be more effective. The transmission mechanism for sectoral capital requirements is reminiscent of the one for the countercyclical capital buffer. In this case, too, relative prices are affected, but the change is between different sectors rather than according to risk. If capital adequacy requirements increase for a certain sector, the funding costs for this sector will thus become higher relative to other sectors. This would tend to reduce lending to that sector. One way of introducing sectoral capital requirements is to adjust the **risk weights** of the assets to a certain sector. For example, this could include increasing the risk weights for mortgages in relation to other loans.[56] This would increase the banks' funding costs for mortgages and would probably mean that mortgage rates would be raised more than other lending rates.

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[51] See also Hopkins, Elisabeth, Lindé, Jesper and Söderström, Ulf (2009), The transmission mechanism and the financial crisis. *Sveriges Riksbank Economic Review* 2009:2. Sveriges Riksbank.

[52] For a review of macroprudential policy and its instruments. see Nordh Berntsson, Christina and Molin, Johan (2012), A Swedish framework for macroprudential policy. *Sveriges Riksbank Economic Review* 2012:1. Sveriges Riksbank and Smets, Frank (2013), Financial stability and monetary policy: How closely interlinked? *Sveriges Riksbank Economic Review* 2013:3, under publication. Sveriges Riksbank.

[53] Basel III is a regulatory framework developed after the outbreak of the financial crisis that places requirements on the banks' capital and liquidity. Within the EU, the new regulations will start to be applied in January 2014 and will be fully introduced in January 2019.

[54] Describing the capital buffer as countercyclical means that it varies over time. In good times, when the economy is strong and systemic risks tend to increase, the banks are required to strengthen their capital positions. When times are worse and systemic risks are realised or decline, the buffer requirement will be lowered so that the banks can cover their losses without having to reduce credit granting. See Juks, Reimo (2012), An application of the Basel standard method for the calculation of the countercyclical capital buffer rate in Sweden, *Economic Commentary* no. 1, 2013. Sveriges Riksbank.

[55] There are also arguments that suggest that the cost of equity can be reduced by lower indebtedness. Lower indebtedness reduces risk for shareholders, meaning that their compensation for risk may thereby become lower. See Modigliani, Franco and Miller, Merton (1958), The cost of capital, corporation finance, and the theory of investment. *American Economic Review,* 48 (3), 261–297.

[56] Determining the capital adequacy requirement involves first multiplying the mortgage with what is known as a risk weight, which reflects the risks in the banks' mortgage lending. This results in a risk-weighted amount, which is the amount that is subject to the capital adequacy requirement.

Unlike the other instruments discussed, the **mortgage cap** (loan-to-value ratio) has a direct impact on demand for credit, as it restricts the size of household loans in relation to the value of the property. The aim of using the mortgage cap as a macroprudential policy instrument is to reduce the risk of an unsustainable accumulation of debt and to increase the banks' resilience by reducing losses on default.

There are also differences between monetary policy and macroprudential policy

Monetary policy and many macroprudential policy tools thus have an impact on similar channels and have similar effects, but there are also decisive differences. Monetary policy plays an important part in household and corporate inflation expectations. These are important for companies' pricing and wage formation, among other areas. Monetary policy is also of great importance to the development of the exchange rate. The effect of the macroprudential policy instruments on these variables is less certain.

Furthermore, there are differences as regards how well the targets for both policy areas can be quantified. The price stability target can be measured and quantified relatively easily using the CPI. Promoting a stable financial system is largely a matter of avoiding events that have a low probability but which may entail major costs. The target is thereby significantly more difficult to capture in terms of a value.

Finally, monetary policy may be a 'broader' tool than the macroprudential policy instruments in certain respects. For example, the policy rate may be more effective than the macroprudential policy instruments if a credit expansion occurs in parts of the financial sector that are not covered by the financial regulations. There is a risk that if regulation only covers certain parts of the financial system it will be circumvented (that so-called regulatory arbitrage will arise). This was expressed by Jeremy Stein at the Federal Reserve´s Board of Governors, as "changes in rates may reach into corners of the market that supervision and regulation cannot". [57]

The link between different policy areas

The link between macroprudential policy and monetary policy is thus a matter of the effects of different tools but also of finding a balance between different objectives. The different objectives of price stability, macroeconomic stability and financial stability are not independent of each other. For example, it is hardly possible to maintain price stability and macroeconomic stability when a financial crisis has broken out. At the same time, financial imbalances often accumulate when the economy is overheated. However, financial imbalances can also accumulate under relatively calm conditions, of which the latest financial crisis is an example. There is also a link that is due to the different policy areas' tools having effects that have different breadths and to the possibility of circumventing financial regulation, as pointed out above. Monetary

[57] See Stein, Jeremy C. (2013), Overheating in Credit Markets: Origins, Measurement, and Policy Responses. Speech at "Restoring Household Financial Stability after the Great Recession: Why Household Balance Sheets Matter", research symposium sponsored by the Federal Reserve Bank of St. Louis, St. Louis, Missouri.

policy can thus in some cases function as a complement to macroprudential policy. Hence, the policy rate and macroprudential policy instruments can both counteract and support each other's objectives.

Macroprudential policy and monetary policy also have links to other policy areas such as fiscal policy and microprudential supervision. Fiscal policy measures such as restrictions to the possibility of deducting interest rate expenditures can contribute towards reducing the risk of financial imbalances accumulating. Measures deemed appropriate for individual institutions from the perspective of microprudential supervision can, put together in certain situations, lead to systemic risks in the financial system. There are thus connections between several different policy areas, not just in crisis situations but also in preventive policy. The financial stability council will provide an important forum for discussions on such connections.

Macroprudential policy affects the macroeconomy and thus the conditions for monetary policy

As different macroprudential policy measures affect economic development, the Riksbank will have to take this into consideration when monetary policy is designed. For example, if demand should be dampened due to macroprudential policy measures, monetary policy will have to take this into account. In a similar way the Riksbank already takes developments in other policy areas such as fiscal policy into consideration.

Fiscal policy influences the level of demand in the economy, among other means via the public sector's incomes and expenses. For example, changes to tax levels have an effect on household consumption and corporate investments and, ultimately, on demand and inflation. The material on which the monetary policy decision is based includes forecasts of economic development, which include the effects of fiscal policy. It is usually assumed that fiscal policy will follow its historical pattern, determined by economic developments and established targets.

The macroeconomic effects of the new macroprudential policy instruments will also have to be integrated into the monetary policy decision-making material. However, there will also be differences, as there is no historical pattern of macroprudential policy to proceed from and because the goals of macroprudential policy are more difficult to quantify than fiscal policy's goals. Consequently, the analysis of how different macroprudential policy instruments influence macroeconomic developments will successively have to be developed and clarified.

Both monetary policy and macroprudential policy affect risks

The unsustainable accumulation of debt can impair the possibility of stabilising inflation around the inflation target and achieving balanced economic development over the longer term. Monetary policy itself can contribute towards the accumulation of financial imbalances. Holding interest rates at a low level for a long time can lead participants in the economy to expect these low interest rates to be permanent. This can mean that they increase their indebtedness to an unsustainable level. The

monetary policy decision therefore involves finding a balance between short-term effects on the prospects for inflation and economic activity and long-term risks associated with the unsustainable accumulation of debt. [58] However, the long-term risks associated with household debt should decrease when macroprudential policy measures are implemented.

The introduction of new macroprudential policy instruments will affect the conditions for monetary policy one way or another. But how they will be affected and at which rate is difficult to ascertain at present. We still have only limited experience of how macroprudential policy works in practice. Moreover, academic research into this area is still in its infancy as regards both empirical and theoretical studies. But as different macroprudential policy instruments are introduced and knowledge increases over how they function in practice, the consequences for monetary policy will gradually become clearer. The Riksbank will need, as before, to monitor and analyse risks and resilience in the financial system, partly to see how these affect economic developments in general and thus monetary policy, and partly to contribute to promoting financial stability.

[58] For a detailed description, see "Financial imbalances in the monetary policy assessment". Article in *Monetary Policy Report*, July 2013. Sveriges Riksbank.